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# FRBSF WEEKLY LETTER

October 24, 1986

## “Recapitalizing” the FSLIC

For 50 years, the direct expenses of the federal deposit insurance agencies were more than adequately covered by the premiums levied on insured banks and thrifts. In the past few years, however, the premium income of the Federal Savings and Loan Insurance Corporation (FSLIC) has not been sufficient to absorb the expenses sustained by the agency in dealing with failing thrifts. As a result, the reserves of the FSLIC have shrunk considerably and are now viewed by the Federal Home Loan Bank Board (FHLBB), which oversees the insurance agency, as inadequate for dealing with the large number of problem thrift cases still outstanding.

To help relieve the FSLIC of its current funding squeeze, the Treasury, in conjunction with the FHLBB, has developed a plan for “recapitalizing” the thrift insurance fund. This plan, which is incorporated into House and Senate bills HR4907 and S2752, respectively, may be the most practical alternative, considering current conditions, for giving the FSLIC the needed boost to its current reserves.

The recapitalization plan, however, provides only short-term relief because of its inability, over the long run, to increase the overall resources available to the FSLIC. The proposal mainly reshuffles future resources to meet current outlays. Without a true recapitalization, a lasting solution to the problem of financial stress on the FSLIC would require a significant reduction in the insurance corporation’s future exposure to losses.

### **The problem and the plan**

With its current reserves, the FSLIC reportedly does not have enough resources to recognize the loss it would sustain if all problem thrifts were liquidated or merged with financial assistance from the insurance corporation. In addition, the FSLIC is quite restricted in its ability to raise additional funds to bolster its reserves. For example, the insurance agency cannot issue its own debt or raise its maximum insurance premium, which is set by the Congress.

To give the thrift insurance fund the needed addition to current reserves, the Treasury and the FHLBB have proposed a new funding option that does not involve direct Treasury assistance or a hike in the insurance premium rate. As shown in the chart, the heart of the plan is a newly created federally sponsored agency, referred to as the Financing Corporation, that would be authorized to borrow funds in the capital market and to pass the proceeds on to the FSLIC. While it is not certain, borrowing by the Financing Corporation could amount to about \$12 to \$15 billion over the next few years.

Under the plan, the 12 regional Federal Home Loan Banks (FHLBs) would advance the Financing Corporation up to \$3 billion, for which they would receive nonvoting capital stock in the Financing Corporation. Most of the FHLBs’ investment (up to \$2.2 billion) would be used by the Financing Corporation to purchase zero coupon bonds whose maturities would match those of the Financing Corporation’s own debt. In that way, the principal amount due on the Financing Corporation’s bonds could be paid off with the proceeds from the zero coupon bonds.

The interest payments on the Financing Corporation’s debt, however, would come primarily from what otherwise would have been the FSLIC’s premium income.

Under the plan, the Financing Corporation would be authorized to receive payments directly from FSLIC-insured thrift institutions. Insurance premiums paid by thrifts to the FSLIC then would be reduced by the amount the thrifts had to pay to the Financing Corporation. (If necessary, some of the FHLBs’ investment also could be used to make interest payments on the Financing Corporation’s debt.)

In exchange for forwarding the borrowed funds to the FSLIC, the Financing Corporation would be given equity in the insurance agency. If \$15 billion were borrowed and passed on to the FSLIC, the insurance agency would issue \$3 bil-

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lion in redeemable stock and \$12 billion in non-redeemable certificates to the Financing Corporation.

While the \$3 billion in stock, which essentially represents the FHLBs' original investment, would be redeemable, the amount eventually repaid would remain uncertain. To provide for repayment to the Federal Home Loan Banks, the FSLIC would make contributions to an "equity return account" beginning in 1997. These contributions would vary with the reserve-to-deposit ratio of the FSLIC. When all of the Financing Corporation's debt matures, which would be no later than 2026, the FHLBs would receive the funds in the equity return account. The repayment realized might be zero or perhaps the original investment plus some return.

## **Budget issue**

A major debate over this recapitalization plan centered on the implications for the federal budget deficit. At issue was whether the funds from the Financing Corporation really would represent equity in the FSLIC or debt obligations of the insurance agency.

Equity contributions received by the FSLIC can be used to offset the insurance agency's expenditures (which are treated as spending in the federal budget), in part, because the insurance agency would have discretion over the distribution of dividends. The Congressional Budget Office (CBO), however, maintained that, under the plan as first proposed, the Financing Corporation's borrowings represented debt obligations of the FSLIC since the FSLIC was directly responsible for the interest costs. As a practical matter, this meant that the FSLIC would have no option but to make those payments, which would not be the case if it were in fact dealing with dividend payments on stock it had issued.

This initial controversy was resolved by giving the Financing Corporation direct access to the insurance premiums paid by thrifts, as discussed earlier. As important as this might be in satisfying the technical aspects of the law, the change is not substantive.

## **Beyond the budget**

In particular, the change in the plan does not alter the fact that only a small portion of the increase in the FSLIC's current reserves would consist of an injection of new resources (the investment of the FHLBs). Most of the boost to reserves would come from borrowings, and a large portion of what would have been the FSLIC's future income stream (that is, payments from thrifts to the Financing Corporation) would be committed to paying the interest on that debt. Such a commitment would greatly reduce the resources available to absorb future FSLIC expenses.

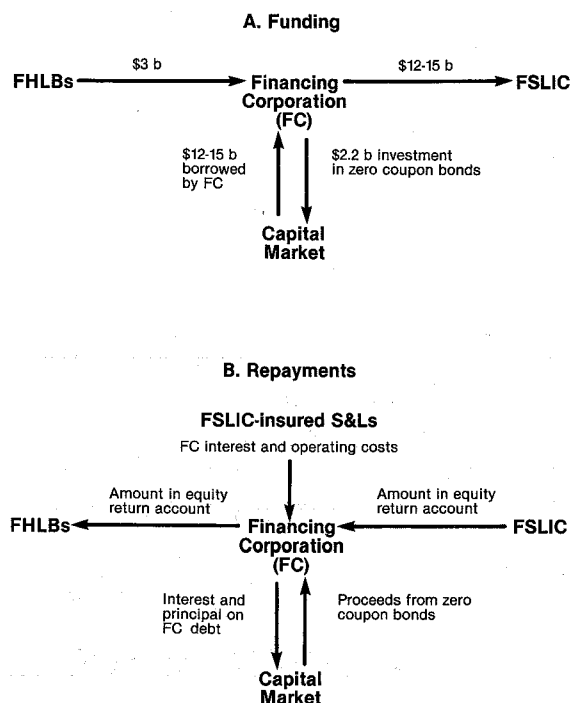
At current market rates, the annual interest cost on federally sponsored agency debt of \$12 to \$15 billion would be on the order of \$1 billion. In 1985, regular premium income to the FSLIC totaled only \$700 million ( $\frac{1}{12}$ th of one percent of thrift deposits). A special assessment raised another \$1 billion ( $\frac{1}{8}$ th of one percent of thrift deposits) in premiums last year. The special assessment, however, has raised some questions concerning competitive imbalance since thrifts have had to pay more than commercial banks for deposit insurance. Indeed, the thrift industry has been pushing hard to get the special assessment phased out by 1991 as part of the recapitalization plan.

The thrift industry has argued that the special assessment could be eliminated because regular premium income would increase as the thrift deposit base expands. A broader deposit base by itself is not the answer, however. Deposit growth would mean not only higher gross income but also greater risk exposure for the FSLIC, everything else the same. Therefore, even if the higher income generated from the growth in deposits were enough to meet the interest on the Financing Corporation's debt, the FSLIC could need additional resources to cover its other expenses in the future.

## **Reducing risk**

The only way the FSLIC can meet its expenses over time, without access to more resources, is to reduce its exposure to losses. The Federal

## The FSLIC Recapitalization Plan



Home Loan Bank Board already has adopted higher capital requirements for insured thrifts to help protect the FSLIC. Currently, the minimum capital requirement for FSLIC-insured institutions is 3 percent of deposits, or about half the required ratio for banks. The FHLBB has announced a new minimum requirement for thrifts of 6 percent of deposits. (The requirement for an individual institution could be higher depending on the composition of its assets and liabilities.) The new standard, which takes effect in 1987, will be phased in over a period of 6 to 12 years. In addition, the FHLBB has *proposed* doing away with the use of regulatory capital (such as net worth certificates issued to thrifts by the FSLIC) to meet the new capital requirements.

These types of policy changes are important to the long-run financial integrity of the FSLIC. But the new capital standards have to be enforced if they are to make a difference. To limit the FSLIC's losses, poorly performing thrifts with "low" capital ratios have to be closed promptly. Such a closure policy is more important to the

FSLIC's ability to remain "self-sufficient" than are innovations such as risk-related insurance premiums.

Even with strictly enforced new capital requirements, capital regulation that is based on book value rather than market value measures of capital could continue to present problems for the FSLIC. This is particularly true if there should be an unexpectedly sharp rise in interest rates. Despite deregulation, exposure to interest rate risk will continue to be a source of potential losses to the thrift industry. As in the past, unexpected increases in interest rates will mean immediate declines in the market value of thrift net worth, with book value net worth adjusting only with a long lag.

Continued reliance on book value could perpetuate the tendency to close institutions too late — that is, when market net worth is already below zero. The degree to which the reliance on book value accounting will result in misleading signals regarding the financial health of thrifts will depend in part on the stability of market interest rates.

### Conclusion

It is important for the FSLIC to have the resources needed to deal with the backlog of problem thrift cases. In this regard, the "recapitalization" plan proposed by the Treasury and the Federal Home Loan Bank Board would significantly boost the insurance corporation's current reserves. However, the net addition to the resources available to the FSLIC over time would be limited. Under the plan, the bulk of the funds would come from the Financing Corporation's borrowings, the interest on which must be paid out of the FSLIC's future income stream.

With much of the future income of the FSLIC earmarked to meet the cost of borrowing funds to pay off its current obligations, the insurance fund would be able to meet its future liabilities without still more resources only if those liabilities were quite small. Failure to realize less than minimal exposure to risk would mean that in the future the FSLIC would have to be truly recapitalized, most likely with resources from outside the thrift industry.

**Frederick T. Furlong**

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

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# Research Department Federal Reserve Bank of San Francisco

## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/1/86	Change from 9/24/86	Change from 10/2/85 Dollar	Percent <sup>7</sup>
Loans, Leases and Investments <sup>1 2</sup>	203,175	1,394	4,848	2.4
Loans and Leases <sup>1 6</sup>	182,380	331	3,372	1.8
Commercial and Industrial	49,801	124	1,805	3.4
Real estate	66,649	924	1,391	2.1
Loans to Individuals	39,662	39	1,778	4.6
Leases	5,619	41	200	3.6
U.S. Treasury and Agency Securities <sup>2</sup>	12,576	1,009	550	4.5
Other Securities <sup>2</sup>	8,218	53	924	12.6
Total Deposits	209,172	6,432	6,439	3.1
Demand Deposits	56,038	5,763	5,726	11.3
Demand Deposits Adjusted <sup>3</sup>	36,861	1,518	9,398	20.3
Other Transaction Balances <sup>4</sup>	17,483	565	3,275	23.0
Total Non-Transaction Balances <sup>6</sup>	135,652	105	2,560	1.8
Money Market Deposit Accounts—Total	46,762	436	1,639	3.6
Time Deposits in Amounts of \$100,000 or more	33,533	396	5,053	13.0
Other Liabilities for Borrowed Money <sup>5</sup>	27,961	2,693	4,240	17.8
<b>Two Week Averages of Daily Figures</b>	Period ended 9/22/86	Period ended 9/8/86		
<b>Reserve Position, All Reporting Banks</b>				
Excess Reserves (+)/Deficiency (—)	20	38		
Borrowings	27	51		
Net free reserves (+)/Net borrowed(—)	7	12		

<sup>1</sup> Includes loss reserves, unearned income, excludes interbank loans

<sup>2</sup> Excludes trading account securities

<sup>3</sup> Excludes U.S. government and depository institution deposits and cash items

<sup>4</sup> ATS, NOW, Super NOW and savings accounts with telephone transfers

<sup>5</sup> Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources

<sup>6</sup> Includes items not shown separately

<sup>7</sup> Annualized percent change